No. 85-1493

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IN THE

# Supreme Court of the United States

OCTOBER TERM 1985

METROPOLITAN EDISON COMPANY,
*Appellant,*

*—against—*

PENNSYLVANIA PUBLIC UTILITY COMMISSION,
*Appellee,*
OFFICE OF CONSUMER ADVOCATE et al.,
*Intervenors.*

PENNSYLVANIA ELECTRIC COMPANY,
*Appellant,*

*—against—*

PENNSYLVANIA PUBLIC UTILITY COMMISSION,
*Appellee,*
OFFICE OF CONSUMER ADVOCATE et al.,
*Intervenors.*

ON APPEAL FROM THE SUPREME COURT OF PENNSYLVANIA

## REPLY OF APPELLANTS TO APPELLEES' MOTIONS TO DISMISS OR AFFIRM

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On Appeal From the Supreme Court of Pennsylvania

## REPLY OF APPELLANTS TO APPELLEES' MOTIONS TO DISMISS OR AFFIRM

This brief of Metropolitan Edison Company ("Met-Ed") and Pennsylvania Electric Company ("Penelec"), the appellants, is submitted pursuant to Rule 16.5 in reply to the motions to dismiss or affirm of the Pennsylvania Public Utility Commission (the "PUC") and the Office of Consumer Advocate (the "OCA"), the appellees. Met-Ed and Penelec are sometimes hereinafter referred to as the "Companies."

## ARGUMENT

### I

### The Investor Interests Criteria of *Hope* Are Constitutionally Mandated If Resulting Rates Will Not Exploit Consumers.

This appeal presents the substantial federal question of whether the decision of the United States Supreme Court in *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) established a requirement, of Constitutional dimension, that utility rates set by regulatory authorities be sufficiently high to maintain the financial integrity of the utilities involved if such rates would not exploit customers.

Since the decision in *Hope* forty-two years ago, this Court has generally been reluctant to review the ratemaking actions of state agencies and courts. Indeed, the *Hope* decision was clearly intended to leave the selection and application of complex rate-setting methodologies in the experienced hands of state regulatory bodies. *Hope* coupled such freedom, however, with the mandate that ratemakers balance the interests of utility customers and investors so as to achieve a "just and reasonable" end result. *Id.* at 602.

*Hope* recognized that utility customers are entitled to rates that are not exploitative. *Id.* at 612. Similarly, it recognized that the investors' legitimate interest is a level of rates which will provide the utility with an opportunity to receive revenues sufficient not only to meet operating expenses and capital costs, but also to assure confidence in the financial integrity of the enterprise so as to maintain credit and attract capital. *FPC* v. *Memphis Light, Gas & Water Division*, 411 U.S. 458, 465-66 (1973) (Douglas, J., the author of *Hope*, summarizing its holding for a unanimous Court).

Because *Hope* found that the investor interests were satisfied in that case, it did not explore the "conditions under which more or less might be allowed." 320 U.S. at 603. As a result, state courts have had little guidance when confronted with a situation, such as the one here presented, in which a public utility commission has refused to set rates at a level which enables the utility to pay dividends on stock, maintain credit, and attract new capital, even though the commission did not find that higher rates would have exploited the utility's customers.

In this case, appellees do not assert that the PUC's orders preserved the Companies' financial integrity and ability to attract capital or that the PUC determined that the Companies' proposed rate increases would have been unreasonable to the public. Appellees argue only that the investor interests specified in *Hope* are not "constitutionally mandated." OCA Brief at 12; PUC Brief at 12-13.*

The *Hope* opinion is to the contrary. Just prior to its discussion of the investor interest components of the criteria for determining whether rates are "just and reasonable," *Hope* quoted from this Court's decision two years earlier in *FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 585-86 (1942), which held that the "just and reasonable" standard prescribed by the Natural Gas Act "coincides with that of the Constitution."

Moreover, in its discussion of investor interests, *Hope* cites, and in many respects paraphrases, the following passage from the opinion of Justice Brandeis in *Missouri ex rel. Southwestern Bell Telephone Co.* v. *PSC*, 262 U.S. 276, 291 (1923):

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*In addition, the PUC argues in its brief that "[r]ates sufficient to assure confidence in the financial integrity of these troubled utilities would have required charging consumers with TMI-1 costs, TMI-2 costs and the uninsured portion of TMI-2 decontamination costs. . . ." PUC Brief at 23. If the record supported such a finding, the PUC should have reached this conclusion a long time ago. The PUC misleads this Court by making such an unsupported and improper statement now.

> The compensation *which the Constitution guarantees an opportunity to earn* is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor; the allowance for risk incurred; and enough more to attract capital. The reasonable rate to be prescribed by a commission may allow an efficiently managed utility much more. But a rate is *constitutionally compensatory*, if it allows to the utility the opportunity to earn the cost of the service as thus defined. (Emphasis added).

Just one page earlier, Justice Brandeis stated:

> The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested *the Federal Constitution guarantees* to the utility the opportunity to earn a fair return.[2] Thus, it sets the limit to the power of the State to regulate rates. (Emphasis added).*

Subsequently, in *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968), this Court again stated that the "just and reasonable" standard construed in *Hope* "coincides" with applicable Constitutional standards. In *FPC* v. *Memphis Light, Gas & Water Division*, 411 U.S. at 474, the Court reaffirmed that

> under *Hope Natural Gas* rates are "just and reasonable" only if consumer interests are protected and if the financial health of the pipeline in our economic system remains strong.

From the outset of the proceedings before the PUC, Met-Ed and Penelec demonstrated that the rates necessary to preserve

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*Footnote 2 to this passage qualifies a utility's Constitutional guarantee exactly as the Companies do here:

> Except that rates may, in no event, be prohibitive, exorbitant, or unduly burdensome to the public. (Citations omitted).

their financial health would not "exploit" their customers. To that end, the Companies submitted evidence that, even if their proposed rate increases were granted in full, the rates would be in conformity with those of other electric utilities in Pennsylvania and neighboring states. While Met-Ed and Penelec agree with appellees that each rate case must stand on its own, the rates set for similar companies operating within the same area certainly provide a touchstone for assessing whether the requested increases were unreasonable.*

Appellees persist, as did the Supreme Court of Pennsylvania, in mischaracterizing the Companies' position. The Companies have never asserted that investor interests are "paramount" or "supersede consumer interests." PUC Brief at 13, 17. Nor have the Companies asked for rate increases that would place them in the "strong financial condition" of the entity in *Hope*. PUC Brief at 22-23. Rather, the Companies' position is that since the PUC did not find—and on the record before it could not find—that their requested rate increases were exploitative, the interests of the Companies' investors described in *Hope* are Constitutionally mandated and not, as the Pennsylvania Supreme Court held, merely "factors to be taken into account." A11.**

*Hope* requires that the PUC do more than consider investor interests. It requires the PUC to "balance" those interests with the interests of consumers. 320 U.S. at 603. Because the PUC failed to determine the level of rates which would exploit con-

*The PUC's gratuitous comment that this standard "would effectively set rates based on those of the worst managed and highest cost utilities in the region" totally lacks substantiation in the record of this case or elsewhere. PUC Brief at 20.

**In view of its determination that "Hope did not establish investor interests of constitutional dimension," the Pennsylvania Supreme Court deemed it unnecessary to remand this case to the PUC for further findings of fact that would more adequately permit appellate review as to whether the investor interests set forth in *Hope* have been satisfied by the PUC's rate orders. A11.

sumers, it could not—and did not—achieve the requisite balancing.

## II

## The "Used and Useful" Test May Not Be Employed To Bar the "Balancing" of Interests Required By *Hope*.

The Pennsylvania Supreme Court miscomprehended the Companies' argument to be that *Hope* requires the setting of rates at a level which will guarantee the Companies' continued financial integrity regardless of countervailing consumer interests. A4, 6. The Companies, however, never contended that there must be an assurance of their financial integrity or concomitant ability to generate profits. Instead, the Companies contend that, under *Hope*, the PUC was Constitutionally obligated to afford them a fair opportunity to operate successfully, compensate investors, and attract new capital so long as ratepayers were not exploited in the process. The Companies further submit that the "used and useful" test attributable to this Court's nineteenth century opinion in *Smyth* v. *Ames*, 169 U.S. 466 (1898) does not excuse a ratemaking agency from satisfying the *Hope* criteria for determining whether the end result of a rate order is "just and reasonable."

In essence, the approach taken by the PUC means that where regulatory commissions find that property is not "used or useful," there can be no "taking" in the Constitutional sense even if the investment in the plant was prudently made. This approach takes what may have been an appropriate element of the "fair value" rule of *Smyth* and confounds it with the "prudent investment" criterion for ratemaking—a criterion that focuses on the investment *in* the enterprise rather than on any particular property employed *by* the enterprise.

The "used and useful" doctrine operates on the basis of hindsight; consumers receive a substantial benefit if a utility makes a successful investment but do not bear the cost of unsuccessful investments. While this approach is consistent with the "fair

value" rule which allows investors the benefit of increased rates if the value of the property appreciates, it is irrelevant to the "prudent investment" approach of *Southwestern Bell*—an approach now nearly universally employed in the United States.

Neither the PUC nor the OCA cites any decision of this Court since *Hope* in support of its view that a proper application of the *Smyth* "used and useful" principle makes ratemaking immune from attack. This is not surprising because the decisions of this Court do not pass on whether the result of any particular methodology of ratemaking is necessarily valid or invalid; they only permit commissions to choose whatever methodology they deem appropriate. *See, e.g., Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581, 601 (1945):

> We do not say that the Commission lacks the authority to depart from the rate base method. We only hold that the Commission is not precluded from using it.

*See also Permian Basin*, 390 U.S. at 805 (upholding rates fixed by a rate base method which differed significantly from that frequently preferred by regulatory authorities).

Thus, the PUC has complete discretion to employ or to depart from the "used and useful" rubric.* But if employment of the "used and useful" method overrides *Hope's* requirement to balance investor and consumer interests, it eviscerates the *Hope* holding.

The PUC never sought to ascertain whether the rates sought by Met-Ed and Penelec would exploit their customers, just as it steadfastly refused to measure the impact of its rate orders by the

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*See *Washington Gas Light Co.* v. *Baker*, 188 F.2d 11, 19 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951), where the court stated that the "used and useful" standard is not a requisite part of the prudent investment theory and that inclusion of even abandoned plant in rate base "may be necessary to assure efficiency and progress in the art and the continued attraction of capital to the enterprise."

investor interest criteria of *Hope*. Indeed, precisely because the PUC focused on methodology and not on end result, it failed to strike the balance required by *Hope*.

## III

## Appellees' Reliance Upon *Market Street Railway* Is Misplaced.

Appellees heavily rely upon this Court's decision in *Market Street Railway* v. *Railroad Commission*, 324 U.S. 548 (1945). In *Market Street*, however, the Court noted that

> . . . most of our cases deal with utilities which had earning opportunities, and public regulation curtailed earnings otherwise possible. But if there were no public regulation at all, *this appellant would be a particularly ailing unit of a generally sick industry*. The problem of reconciling the patrons' needs and the investors' rights in an enterprise *that has passed its zenith of opportunity and usefulness, whose investment already is impaired by economic forces,* and *whose earnings possibilities are already invaded by competition from other forms of transportation, is quite a different problem.*

*Id.* at 554 (emphasis added). The Court also pointed out that a prior increase in fares had not halted the decline in the street railway's traffic and revenue. *Id.* at 555.

The railway in *Market Street* was "hopelessly undermined," "could not attract capital on any possible rate," and had been effectively replaced by a more efficient municipal line. *Id.* at 566. In contrast, there exists today an urgent public need for electric service. The inability of Met-Ed and Penelec to achieve earnings that would meet the *Hope* criteria is solely attributable to the inadequate rates set by the PUC and not to outside economic factors such as existed in *Market Street*.

## IV

### The Issue Here Presented Is a Recurring Question of Substantial Public Importance.

Appellees attempt to make much of the fact that a similar issue was raised in a Jurisdictional Statement filed by an affiliate of appellants in *Jersey Central Power & Light Company* v. *Board of Public Utilities*, October Term 1983, No. 83-1478. They do not, however, deny the importance of the issue raised and, indeed, the instant case is one of a series of cases involving the question of whether there has been a confiscation of the property of public utility investors. *See, e.g., Jurisdictional Statement of Northern Indiana Public Service Company*, October Term 1985, No. 85-1610 and the cases cited therein. Nor has this question been limited to state courts. *See Jersey Central Power & Light Co.* v. *FERC*, 730 F.2d 816 (D.C. Cir. 1984), *rev'd on reh'g*, 768 F. 2d 1500, *vacated for reh'g en banc*, 776 F.2d 364 (1985), now pending before the Court of Appeals for the District of Columbia Circuit.

The decision in *Hope* was a valuable corrective to the all too frequent involvement of federal courts in ratemaking activities over the previous fifty years. It has recently developed, however, that state courts are not giving adequate attention to the requirements of investor interests and need to be reminded of *Hope*'s continuing vitality. That this Court decided not to provide such a reminder two years ago does not dispose of the issue; it has often rejected both long and newly established interpretations of law. *See, e.g., West Virginia Board of Education* v. *Barnette*, 319 U.S. 624 (1943); *Erie* v. *Tompkins*, 304 U.S. 64 (1938). To say, as appellees do, that this Court should preclude itself from reviewing a vitally important question affecting one of the Country's essential industries fails to recognize the developments of the past two years and unduly limits the Court's role.

## Conclusion

For the foregoing reasons and the reasons in their Jurisdictional Statement, the Companies respectfully submit that the Constitutional question presented by this appeal is of substantial public importance and that appellees' motions to dismiss or affirm should be denied.

Respectfully submitted,

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